

October 31, 1991

**COORDINATED ISSUE
GROUND TRANSPORTATION INDUSTRY
TRACKAGE RIGHTS AND OTHER PROTECTIVE CONDITIONS**

ISSUE:

Whether expenditures relating to efforts to defeat a proposed merger and to obtain protective conditions from the ICC resulted in the creation of an intangible asset as well as whether such expenditures constitute non-deductible capital expenditures.

FACTS:

Taxpayer identified expenditures in 1981 and 1982 incurred in connection with its attempt to defeat the proposed merger of the X and X railroads, and to obtain protective conditions. These were deducted as operating expenses. No portion was capitalized.

The types of expenses connected with the efforts are legal and professional fees, in-house salary, and related travel of management personnel participating in the efforts, as well as expenses of witnesses testifying on the taxpayer's behalf.

On X, X and X filed applications with the Inter-state Commerce Commission (ICC) to merge. On X, and ICC approved the merger subject to various protective conditions. One of the protective conditions was the award to taxpayer of trackage rights over the pre-merger X line between X, X, and X.

The ICC is the federal agency which regulates the railroad industry. One of its responsibilities is to approve or disapprove mergers. The statutory criterion for approving a merger is whether it is consistent with the public interest. There are numerous factors considered in determining whether a merger is consistent with the public interest. The two most important are its effect on competition and the adequacy of transportation to the general public. In a Policy Statement dated February 2, 1981, the ICC announced, in regard to consolidations, that it performed:...a balancing test weighting the potential benefits to applicants and the public against the potential harm to the public." In weighting the effects of a consolidation, the ICC is authorized to impose protective conditions. In determining whether to impose protective conditions, their overriding concern is the public interest. Conditions are imposed to eliminate or ameliorate potential harm to the public resulting from a proposed merger. Most mergers have both positive and negative impact on the public. Normally there are proponents and opponents of a proposed merger. Normally protective conditions are imposed when a merger is approved. The result is some railroads which are not a party to the merger are granted certain operating rights which constitute valuable

intangible assets such as trackage rights. Recipients of such right apply for them. Most proposed mergers trigger application for protective conditions by many railroads. Although the protective conditions are awarded to protect the public, they often result in a substantial benefit to the fortunate recipient.

The administrative process employed by the ICC involves all parties affected by the proposed merger, including other railroads, shippers, the general public, Federal, and State agencies. The process enables each participant the opportunity to express its position and present evidence supporting that position including testimony of experts. It also allows the participant to cross-examine the witnesses of other participants as well as the applicant.

In its filings with the ICC, taxpayer has consistently opposed the merger as anti-competitive and sought protective conditions in the event the merger was approved.

In its initial filing regarding this matter, taxpayer voiced its opposition and announced it would seek trackage rights, Independent Rate Making Authority (IRA), and certain other protective conditions.

In its second filing with the ICC, taxpayer requested an additional condition; trackage rights over the lines of the X as a alternative to the IRA.

On X, taxpayer formally applied for trackage rights over the X and X lines. In its Opening Brief before the ICC, taxpayer stated its opposition to the merger and sought trackage rights over the X line, the IRA over the X line, and certain other pro-competitive conditions, but did not include the request for trackage rights over the X line.

In its Reply Brief dated X, it restated its opposition to the merger and sought only two protective conditions; i.e., trackage rights over the X and the IRA.

Transcontinental rail traffic west of X flows through three corridors; i.e., the northern corridor which serves the X and which is served primarily by the X, the southern corridor which serves X X and which is served by the X and X railroads, and the X corridor which serves Northern and Central X. Taxpayer operates in the X corridor and competed with X for transcontinental traffic by connecting on its east ends with X and X. On its X end, it connected with X and X.

It was feared by most opponents of the merger that if the merger was approved without conditions the merged entity would gain complete control of the X corridor which would result in an anti-competitive situation. The ICC agreed and as a result granted the protective condition. The reasoning was the new entity would favor its own routes and

could offer single line service via the old X, X and X routes. It was feared the X line between X and X would be abandoned since the X has another direct route to X. It was further feared the single line service offered by the new system had an inherent advantage over alternative routes through the X corridor such as X or X. It was feared that since X and X had alternative transcontinental routes through the X and X corridors, they would abandon the X corridor. The result being the new entity would be the only transcontinental carrier in the X corridor which would create the ant-competitive situation.

The X corridor handled X percent of the transcontinental traffic before the merger and X percent of the transcontinental traffic to and from X and X. There is no doubt the merger, without conditions, would have given the new entity complete dominance over the X corridor and put Taxpayer in the position of being merely a small railroad limited to handling traffic originating and terminating on its line. It was believed the unfriendly connections on its east would hamper the ability of coal producers in the X X served by taxpayer to market coal in the major markets to the east.

Taxpayer successfully argued the proposed merger would create an anti-competitive situation in the X corridor. In retrospect, it appears certain the ICC would have reached this conclusion. The United States Departments of Justice and Transportation recognized the anti-competitive situation and conditioned their approval on the granting of protective conditions. The Office of Special Counsel recommended the merger be denied for several reasons including its major anti-competitive consequences. Most railroads opposed the merger as anti-competitive seeking either complete defeat or conditioning approval upon the granting of various protective conditions. All of these groups employ experts who are familiar with the laws governing the ICC, its administrative procedures as well as the criteria considered by ICC in reaching its decisions.

Taxpayer's accounting system does not identify and classify expenditures according to projects such as this merger. Records identifying, classifying, and describing the nature, amount and purpose of expenditures connected with the merger are not readily available. Due to this lack of records, it was necessary to obtain estimates from officers of the corporation.

A senior executive was interviewed on X, at which time he stated, in response to the examiner's request for an estimate, that taxpayer's efforts might be divided into the following categories:

1. Defeating merger.
2. Obtaining trackage rights over the X.

3. Obtaining trackage rights and the IRA over the X.
4. Obtaining other protective conditions which he deemed to involve very little effort and hence allocated nothing to them.

He estimated that 60 percent, 20 percent, and 20 percent of the effort should be allocated to defeating merger, trackage rights over the X, and the IRA and trackage rights over the X, respectively. He maintained the conditions sought should be viewed as two efforts; i.e., the east and the west efforts. The east effort being to ameliorate the harm at its east by seeking the trackage rights between X and X; the west effort being to ameliorate the harm to its west by either the IRA or trackage rights over the X. The efforts were designed to combat the east and west end problems caused by the proposed merger.

Based upon the interview of X, a request was made for an allocation of costs to the various efforts and the basis for the allocation. In reply, it was stated 20 percent of the total costs should be allocated to obtaining the trackage rights and the balance allocated to the unsuccessful effort to defeat the merger.

The inconsistency regarding the portion of the effort devoted to defeating the merger was questioned, that is, 60 percent vs. 80 percent, and the portion of the effort assigned the west end problem, that is, zero percent vs. 20 percent. It was stated the efforts connected with the latter were 20 percent but since they did not obtain the sought after condition it was deemed to be an unsuccessful effort.

Protective conditions include trackage rights and the Independent Rate-making Authority (IRA) which are issues in this case. Trackage rights amount to an ICC mandated lease. In this case, taxpayer applied for trackage rights over the X track between X to X under which it was to pay an annual lease fee plus share certain operating and maintenance costs. The X did not want to lease the track to taxpayer but was required to do so as a condition for ICC approving the merger. The result of the award was the taxpayer extended its operating territory. The award enabled taxpayer to improve its position as a transcontinental carrier. In addition, taxpayer benefited from the ability to offer its shippers direct line service to X.

The IRA is a protective condition which allows one railroad to exercise independent pricing initiative on joint rates involving another carrier. In this case, taxpayer requested an IRA over the X lines. Its request for the IRA was denied by the ICC on X, but successfully appealed to the U.S. Court of Appeals for the District of Columbia in a decision rendered X. In X taxpayer dropped its request for the IRA.

Under the proposed IRA, taxpayer would have paid the merged system a divisional share of the revenue generated over the X line based on the greater of the rate it

quoted or the rate the merged system charged its shippers. Taxpayer could have benefited from the IRA in the following ways:

1. It could maintain competitive rates. It could underprice or even take a loss on shipments over the X line in an effort to attract transcontinental traffic and other business away from the merged system.
2. It could have eliminated the time consuming process of obtaining rate concurrences for shipments over the X line.

The result would have been to enhance its position as a transcontinental carrier. Furthermore, it would have placed taxpayer in a stronger bargaining position with the X, its only other connection to the X coast. Taxpayer stated the reason for requesting the IRA was its contention the merged system would foreclose it from participating in X traffic because X would favor X and X would favor its own southern routes.

The trackage rights agreement executed between X, X, and taxpayer pursuant to the ICC award was dated X. It specified the term of the agreement begins on the date of consummation of the merger and runs for 199 years. However, since the trackage right award is subject to extension by the ICC, its life is not determinable.

The award has substantial value. In the administrative proceeding before the ICC, taxpayer testified the award would result in a gain of \$40 million annually in gross revenue.

In a Prospectus dated X issued by X in connections with a sale of securities (Senior Subordinated Notes and Subordinated Debentures of taxpayer), it is stated on X that the railroad's operations increased significantly when it "acquired" the trackage rights. It states the acquisition expanded the railroad's reach to the X.

LAW AND ARGUMENT

Section 162(a) IRC allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on a business. All of the expenses at issue are Section 162 expenses. The question is whether these Section 162 expenses are also capital expenditures.

Section 263 IRC requires expenditures incurred in acquiring capital assets to be capitalized even when the expenditure might otherwise be deductible under Section 162. (Section 161 IRC, Commissioner v. Idaho Power Co. (74-2 USTC 9521) 418 U.S.1, (1974).

Expenditures which serve to create or enhance a separate and distinct additional asset are capital expenditures within the meaning of Section 263 IRC. Commissioner v. Lincoln Savings and Loan Association, (71-1 USTC 9476) 403 U.S. 345 (1974).

Expenditures made to protect or preserve a taxpayer's business are deductible as business expenses if they do not result in the acquisition of a capital asset. (First National Bank of Skowhegan, Maine, 35 BTA 876 (1937) acq 1937-1 C.B. 9).

Expenditures which secure a right to conduct a certain business such as a franchise, license, lease or approval of a regulatory agency are capital expenditures under Section 263 IRC. Shutler v. United States, (73-1 USTC 9145) 470 F. 2nd 1143 (10th Cir. 1972) cert. denied, 411 U.S. 982 (1973).

Costs of acquiring a lease are not deductible under Section 162 IRC (Wells-Lee v. Commissioner, (66-1 USTC 9405) 360 F. 2nd 665, (8th Cir. 1966)).

Costs connected with obtaining from the ICC a certificate of public convenience and necessity which would allow a trucking firm to operate nationwide were found to be an intangible asset required to be capitalized under Section 263 IRC. Chandler Trailer Convoy, Inc., 32 TCM 1372 Dec. 32, 272(M) TC Memo 1973-285: Chandler already had routes and was attempting to obtain a broader ICC certification.

Section 1.167(a)-3 of the Treasury Regulations prohibits depreciation of intangible assets whose useful life is not limited.

Acquisition costs include indirect labor expenses including vacation and holiday pay as well as employment taxes. Idaho Power Co., supra.

Capital expenditures relating to unsuccessful acquisition efforts are deductible as losses under Section 165(a) IRC if such efforts do not result in the creation or enhancement of a capital asset. Expenditures made with the contemplation they result in the creation of a capital asset cannot be deductible even though that expectation is subsequently frustrated or defeated. Radio Station WBIR, Inc. (Dec. 23, 416) 31 T.C. 803 (1959), Central Texas Savings & Loan Association v. U.S. (84-1 USTC) 731 F. 2nd 1181 (5th Cir. 1981).

A loss is allowed when the transactions completed and closed Section 1.165-1(b) of the Treasury Regulations.

The primary purpose for making an expenditure does not determine whether an expenditure is a business expense or capital expenditure. Woodward v. Commissioner, (70-1 USTC 9348) 397 U.S. 752, 575 (1970). U.S. v. Gilmore, (63-1 USTC 9285) 372 U.S. 39 (1963).

The origin and character test as developed in Gilmore and Woodward is the controlling test in determining whether an expenditure is to be classified as business or personal. It also is appropriate in determining whether an expense is capitalizable under Section 263. There is no question the origin of taxpayer's involvement stems from its need to protect its business. The character of taxpayer's efforts in this matter is open to subjective evaluations. The facts show effort to defeat the merger and efforts to obtain protective conditions. Testimony indicates the primary purpose and objective of the taxpayer's efforts were to defeat the merger. The ICC proceeding dealt primarily with whether or not to approve the proposed merger.

In Blitzer v. U.S. (82-2 USTC 9465) 684 F. 2nd 874, the Court of Claims stated, "In determining whether an expenditure having a dual purpose, capital and expense, is deductible we may not look to its primary purpose, but must allocate the portion applicable to each."

A taxpayer has the burden of proof to establish all facts necessary for a deduction.

TAXPAYER'S POSITION:

Taxpayer would allocate the effort, as follows:

1. 60 percent to defeating the merger.
2. 20 percent to trackage rights; i.e., the east problem.
3. 20 percent to the IRA and trackage right; i.e., the west problem.

Therefore taxpayer contends that sixty percent of the costs relate to its efforts to defeat the merger and are deductible as paid or incurred in 1981 and 1982.

Twenty percent of the costs relate to the unsuccessful effort to obtain the west end conditions and should be allowed as a deduction as paid or incurred. The balance of the cost, twenty percent, is properly capitalizable as an intangible asset not subject to depreciation or amortization.

In rebuttal of taxpayers position, we believe the 60 percent allocated to defeating the merger can not be deducted as a Section 162 expense and must be allocated to the trackage rights.

There is authority for allocating costs to actual efforts (Blistzer, supra.) if such efforts do not result in the enhancement or creation of an asset. There is no basis for allocating expense to defeating the merger and claiming a Section 162 deduction if Section 263

expenditures are involved, Lincoln, First National Bank of Skowhegan, Maine, Radio Station WBIR, Inc., and Central Texas Savings and Loan Association, supra.)

As an alternative, taxpayer might argue the cost of defeating the merger should be allocated between the two conditions sought. Using taxpayer's percentages, the result would be 50 percent of cost is allocable to the trackage rights and 50 percent to the X end problem. That is, since the efforts are divided equally between the X and X end problems the total costs are allocable on a 50-50 basis.

However, we are not willing to accept a 50-50 allocation because the cost connected with each condition has not been documented and because our position is deemed correct.

CONCLUSION:

The collective efforts should be viewed as a single effort to defeat the merger which resulted in the creation of an intangible asset, trackage rights. Accordingly, the entire sums at issue are capitalized in accordance with the Supreme Court decision in Lincoln, supra. These include expenditures identified by the company plus a computation for indirect labor and overheads.

Alternatively, (1) no deduction as loss is permitted in 1981 because the proceeding was in process. (2) Costs relating to the unsuccessful efforts to obtain other protective conditions can not be identified, therefore a loss could not be allowed even if it were determined the efforts were eventually abandoned. (3) Even if costs of unsuccessful efforts could be identified, no loss is allowable during 1981 and 1982 because efforts to obtain the protective conditions were not abandoned until 1985. (4) Costs connected with the unsuccessful efforts to obtain protective conditions resulted in the trackage rights award to taxpayer and the award of other protective conditions to other railroads which enhanced taxpayer's competitive position.